Government of **Western Australia**
Small Business Development Corporation

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Western Australia

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Dear Mr Wein

Final Submission to the Review of the Franchising Code of Conduct

The Small Business Development Corporation ('SBDC') welcomes the release of the *Discussion Paper: Review of the Franchising Code of Conduct*, in line with the commitment made by the Federal Government in recent years to review the Franchising Code of Conduct ('the Code') in 2013.

This final submission replaces the interim version that was provided on a private and confidential basis during the caretaker period ahead of the General State election on 9 March 2013. The following content makes minor amendments to what was contained in the interim submission.

Background

The SBDC is an independent statutory authority of the Government of Western Australia established to facilitate the growth and development of small businesses in the State. One of the agency's key strategic objectives is to take a lead role in influencing the policy and regulatory environment affecting the small business sector in Western Australia.

As part of the agency's core role in providing advisory services to new and existing businesses in Western Australia, the SBDC offers specialist franchising advice and guidance to clients operating in, or considering entry into, a franchise system. In this capacity, the SBDC provides practical assistance to franchising participants to help them improve their level of understanding of their rights and obligations, both in relation to their particular franchise agreement as well as on the broader regulatory framework (i.e. the Code and the *Competition and Consumer Act 2010 (Cth)* that underpins it).

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The SBDC also provided secretariat support to the then State Government's *Inquiry into the Operation of Franchise Businesses in Western Australia* (known as the 'Bothams Inquiry'[1]), as well as comprehensive advice to the Western Australian Parliament regarding the potential impacts on franchising participants and the possible unintended consequences of separate, standalone regulation of franchising in this state[2].

More recently, the State Government appointed Western Australia's first Small Business Commissioner (who commenced in January 2012) to among other things:

- enhance a competitive and fair operating environment for small business in the state; and
- provide alternative dispute resolution ('ADR') services in respect of small business disputes.

Through this new small business ADR service, which commenced operating on 26 March 2012, the SBDC is able to receive and investigate complaints about business-to-business disputes, including in relation to the "unfair market practices" of other businesses. This enables the SBDC to hear disputes related to the franchising relationship, including disagreements between franchisees and franchisors.

The Current Review

While not able to specifically address all questions in the Discussion Paper, this submission provides commentary on the following issues:

- Efficacy of the recent Code amendments and the case for further disclosure;
- Good faith in franchising and state-based regulation; and
- Dispute resolution and Code enforcement.

Efficacy of the recent Code amendments and the case for further disclosure

The SBDC believes that the most recent changes to the Code have positively impacted on the conduct of parties involved in franchising.

The latest statistics[3] from the Code's regulator, the Australian Competition and Consumer Commission ('ACCC'), do not give an indication of systemic problems in franchising in Western Australia. The SBDC notes that of the 488 franchise-related complaints received by the ACCC during 2012, 11.9% (or 58) originated from this state. By no means is this a significant number,

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[1] See: www.smallbusiness.wa.gov.au/assets/Corporate-Information/franchise-inquiry-report2008.pdf.
[2] Specifically, the Private Members' Franchising Bill 2010 (WA), as introduced by Mr Peter Abetz MLA, and Franchise Agreements Bill 2011 (WA), as introduced by the Hon Ljiljanna Ravlich MLC.
[3] Australian Competition and Consumer Commission, "Small business, franchising and industry codes – 1 July 2012 to 31 December 2012", see: www.accc.gov.au/content/index.phtml/itemId/1099722.

given that there are thousands of franchise businesses in Western Australia, and *prima facie* does not suggest a sector in trouble or plagued by endemic misconduct by rogue operators.

According to the ACCC, the leading causes of franchise-related complaints received by the regulator last year were (in descending order)[4]:

- misrepresentations (most likely in relation to unrealistic turnover or sales figures);
- disclosure issues;
- unconscionable conduct;
- terminations; and
- exclusive dealing (supply chain) issues.

It is noted that specific remedies already exist under the Code and the *Competition and Consumer Act 2010 (Cth)* to address the majority, if not all, of these concerns.

In the SBDC's opinion, the enhancements made to the Code's disclosure requirements in 2008 and 2010 have improved the timeliness and relevance of information provided to prospective and renewing franchisees. Importantly, these changes have ensured they are better able to make a more fully informed commercial decision based on a clear understanding of what their respective rights, responsibilities and obligations are *prior* to entering into the contract. Certainly the furore evidenced in recent years – especially around end of agreement rights – has subsided somewhat, and there has been a noticeable decline in public scrutiny of the franchising sector[5].

The SBDC is of the firm view that improving the level of up-front knowledge of prospective and renewing franchisees can potentially prevent many problems from developing in the first place and becoming grounds for dispute later. Our experience suggests that disputes in franchising are often related to mismatched expectations or a misunderstanding of rights and obligations under a franchise agreement.

Furthermore, the SBDC contends that the onus should remain on prospective and renewing franchisees to undertake appropriate and thorough due diligence before entering into or renewing a franchise agreement. Above all else, it is critical that those looking to enter into a franchise system understand the inherent risks associated with franchising[6], as with running any business.

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[4] Ibid.

[5] It is understood that most of the more recent press reports regarding problems in franchising relate to misrepresentations, especially about projected turnover or profitability (as is the case in current claims against the franchisors of Pie Face and the Bank of Queensland), or the demise or insolvency of several high profile *franchisors* (including *inter alia* Borders, Kleenmaid, and Angus & Robertson). In the case of Pie Face, the current multi-million dollar claims for losses and damages against the franchisor also pertain to the non-disclosure of key operating expenses.

[6] The risk of business failure will always exist, regardless of the type of business (franchised or otherwise), the support provided by relevant parties (such as franchisors) or the business acumen and/or experience of the individual business operator.

In any area of major contract where large, long-term investments with considerable risks are involved, there will always be those individuals that don't avail themselves of impartial, expert advice and will enter into particular contractual arrangements without full clarity of what this means for them. However, the SBDC does not believe that this is an area that necessitates further regulatory reach (specifically, that the Code prescribe that prospective franchisees *must* seek out independent advice prior to entering a franchise agreement).

In the SBDC's opinion, the cover sheet and waiver form included as part of the disclosure documentation are considered ample in terms of highlighting the risks associated with running a franchise and encouraging independent assessment of the feasibility of the business proposal.

In recognition of the importance that improved knowledge and better educated franchising participants makes, the SBDC welcomes the Franchise Council of Australia's ('FCA') adoption of the United States-based professional accreditation program, the Certified Franchise Executive program. This program is aimed at improving franchising relationships and encouraging standards of excellence by certifying the highest standards of quality training and education among franchisors, franchisees and suppliers.

According to its Chairman, Mr Michael Paul, the FCA sees education "as a critical element in lifting standards across the board"[7], a sentiment shared by the SBDC. As the old proverb goes, "Forewarned is forearmed", and at the end of the day franchisees must take responsibility for their own due diligence.

In relation to the question of whether additional disclosure is required, the SBDC believes that further consideration could be given to improving franchisor disclosure in regards to the following matters:

- The rights of franchisees in the event of the franchisor's insolvency, though the SBDC would stop short of calling for franchisees of a franchise system to be legally recognised as secured creditors of that franchisor;
- The rebates provided by franchisors to suppliers, including the amount and purpose of them. In this regard, the SBDC notes a recent article by the Franchise Advisory Centre that concluded, "The very existence, nature, size and extent of rebates can be a potential source of conflict between franchisees and franchisors"[8]; and
- Greater clarification around the entitlement to compensation for the goodwill that can be apportioned to the effort contributed by a franchisee, though as Bothams noted, "While legally recognised as a form of property, courts have found goodwill difficult to define"[9].

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[7] See: www.franchise.org.au/images/CFE_Program_launch.pdf.

[8] Mr Jason Gehrke, Franchise Advisory Centre, "The good and bad of franchise rebates", first appeared on the SmartCompany website on 5 February 2013.

[9] www.smallbusiness.wa.gov.au/assets/Corporate-Information/franchise-inquiry-report2008.pdf, pg.63.

Good faith in franchising and state-based regulation

Although enhancements to increase the transparency, quality and timeliness of disclosure by franchisors and improve the conduct of franchising parties have been made to the Code in recent years, the spectre of separate state-based regulation of the sector remains. In particular, it is noted that ongoing calls for the introduction of standalone regulation at the state level typically go hand-in-hand with demands for the inclusion of a good faith standard to underpin franchising conduct.

As franchising is largely a national pursuit involving national brands, it is preferable for any regulatory response to be pursued federally. The risk of establishing uneven playing fields across the country, characterised by a hotchpotch of different rules and regulations across jurisdictional borders, is at stake if reforms are pursued in an inconsistent and sporadic manner by individual state governments.

As a general principle, the SBDC does not support the duplication of federal regulation at the state level (in just one or a few state jurisdictions) where the Commonwealth has a legitimate role, as this typically translates into additional compliance costs for small business market participants. Further to this, the SBDC has previously argued in relation to standalone legislation in Western Australia[10] that the introduction of state-based regulations could significantly damage the way franchising is conducted in Australia and lead to other unintended consequences. These include:

- adding additional compliance burdens (particularly for franchisors, who would invariably pass this cost on to franchisees);
- creating uncertainty in the franchising relationship by narrowly defining a statutory obligation for good faith so that expert clarification (which typically comes at a cost) is required to understand what it entails;
- jurisdictional confusion (especially in cases where the franchisor and franchisee in dispute reside in different states) as well as additional costs to the state in enforcing compliance and prosecuting misconduct;
- the potential for perverse outcomes, including *increased* disputation in the sector and uncertainty of contract (i.e. about whether the terms of a franchise agreement are enforceable); and
- establishing a precarious precedent for other areas of federally regulated oversight of the business community.

Unilateral action by a state or territory government to regulate the franchising relationship would also be contrary to recent efforts to enhance the operating environment for the business community and remove jurisdictional differences in state fair trading legislation, most notably through the Seamless National Economy reform agenda of the Council of Australian Governments ('COAG').

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[10] See: www.parliament.wa.gov.au/parliament/commit.nsf/a7b778ee55fef62a4825772700174a2c/5ebba98e818c14b34825783b000fb86c?OpenDocument .

Regardless of this, concerns remain that short of federal government action to incorporate some standard of good faith into the franchising relationship under the Code, pressure will likely continue to mount on state governments to regulate in this space.

The following comments address some of the specific questions contained in the Discussion Paper in relation to good faith in franchising.

How effective is section 23A of the Code, which provides that nothing in the common law limits the obligation to act in good faith? [Question 16]

The SBDC notes that the Private Member's Franchising Bill 2010 (WA), which would have regulated franchising at the state level and required franchising conduct to be subject to a good faith obligation (with monetary penalties for breaches), was defeated in the Legislative Assembly on 2 November 2011.

As the Economics and Industry Standing Committee ('EISC') *Inquiry into the Franchising Bill 2010* ('the EISC Inquiry') report claimed[11]:

> *"Undoubtedly, the [commonwealth] government's decision not to accept the Ripoll Report's recommendation on the duty of good faith was one of the major reasons behind the introduction of the Franchising Bill 2010. The express duty of good faith in clause 11 of the Bill has been included to address this gap in the Code. In contrast to the concerns of the commonwealth government, the Explanatory Memorandum states that its inclusion will provide 'certainty for all participants in the franchising industry in [Western Australia] regarding the nature and scope of that duty."*

Despite the intent of the Franchising Bill 2010, the EISC Inquiry concluded that[12]:

> *"..the unconscionable conduct provisions at section 22 of the CCA (formerly section 51AC of the TPA) were developed and have been amended with the needs of the franchising industry in mind. The continued monitoring of these provisions and the recent changes to the consumer law in Australia demonstrate that successive federal governments and the commonwealth parliament as a whole have been committed to providing an effective law.*
>
> *It is the Committee's view that the issues it has identified with clause 11 of the Bill [pertaining to the introduction of a good faith standard in the franchising relationship] will result in a similar situation as has occurred with the unconscionable conduct provisions; that is, a long process of amendment and improvement. While this is not a reason not to enact legislation, the Committee believes that any provision that proposes a move away from a national legislative framework for franchising must have a real and immediate effect. Anything less than that would duplicate the same problems that have been experienced under the current legislative framework."*

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[11] Economics and Industry Standing Committee of the Legislative Assembly, *Inquiry into the Franchising Bill 2010*, Report No.7, 2011, pgs.45-46.

[12] Ibid, pg.52.

Finding 14 of the EISC Inquiry is particularly instructive. It states[13]:

> *"If a general statutory obligation to act in good faith is to be imposed into franchising legislation, it should be pursued at the commonwealth level during the next review of the effectiveness of recent amendments in 2013."*

In its concluding statement on good faith, the EISC stated[14]:

> *"The Committee feels that these amendments will address many of the problems cited in earlier inquiries and lift the standards of conduct in the franchising industry. However, should recent amendments prove inadequate, the Committee is not opposed to the development of a general duty of good faith for franchising – at the commonwealth level."*

What specific issues would be remedied by inserting an obligation to act in good faith into the Code which would not otherwise be addressed under the unwritten law or by the ACL? [Question 17]

In relation to section 23A of the Code, the EISC received submissions that an obligation for good faith needs to be included as a statutory requirement because as an implied duty at common law it requires individual franchisees to take court action to establish its application. This lengthens court proceedings making them more costly and generally beyond the reach of most small business franchisees.

Finding 15 of the EISC Inquiry contains statements[15] that are relevant to this issue, as follows:

> *"The major impediment to justice is the cost of accessing the courts, particularly for small franchisees.*
>
> *Good faith provisions, such as that included in clause 11 [of the Franchising Bill 2010], rely on accessing courts and therefore do not significantly improve access to justice.*
>
> *A statutory definition of good faith should reduce court debate over whether good faith applies to a franchising agreement, notwithstanding the current common law duty to act in good faith.*
>
> *The Committee was unconvinced that the narrow definition of good faith as articulated in clause 11 would reduce overall court time or otherwise improve access to justice. Indeed it could lead to greater debate regarding the parameters articulated in the Bill."*

The view appears to be that a mandatory good faith obligation, together with pecuniary penalties, in the Code would produce improved behaviour in the franchising sector.

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[13] Ibid, pg.58.
[14] Ibid, pg.58.
[15] Ibid, pg.62.

If an explicit obligation of good faith is introduced, should 'good faith' be defined? If so, how should it be defined? [Question 18]

In relation to the proposed definition of "act in good faith" in clause 11(1) of the Franchising Bill 2010, which defined it as meaning "to act fairly, honestly, reasonably and cooperatively", the EISC Inquiry concluded[16]:

> *"The Committee recommends that, if the Franchising Bill 2010 is to proceed, any statutory obligation to act in good faith should be left undefined."*

This conclusion was supported by the Western Australian Government in its response to the EISC Inquiry report[17].

As part of its inquiry, the EISC received advice from the Law Council of Australia on the definition to the effect that[18]:

> *"While the law is capable of determining honesty with some precision, the same cannot be said in relation to 'fair', 'reasonable', or 'cooperative' as they are employed in this context. The concepts have been drawn from common law doctrine and applied in the Bill bluntly, potentially disconnecting from the nuance of their origin."*

An example provided by the Law Council of Australia relates to the term "cooperation" in the proposed definition, as follows[19]:

> *"The common law concept of cooperation in good faith allows for a court to balance an obligation to do all that is necessary to 'secure the success of the contract' against the economic self-interest that each party necessarily and legitimately pursues. By contrast, a legislative requirement to act cooperatively, without reference to any limitation, qualification or balancing process, is a recipe for misapplication and dispute. On a broad application, this concept may prevent a party from pursuing its legitimate business interests."*

As a result of receiving this and other submissions, the EISC was of the view that[20]:

> *"...codifying the common law concept of good faith with an exhaustive definition using four imprecise terms will cause uncertainty. Additionally, litigation will not be decreased and may even be increased.*

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[16] Ibid, pg.58.

[17] Government Response to the Western Australian Legislative Assembly's Economics and Industry Standing Committee Report No.7 – Inquiry into the Franchising Bill 2010 (see www.parliament.wa.gov.au/C8257837002F0BA9/%28Report+Lookup+by+Com+ID%29/BE0D68AF637A8A43482578B800144888/$file/Government+Response+-+EISC+Report+No+7.pdf), pg.5

[18] Economics and Industry Standing Committee, *Inquiry into the Franchising Bill 2010*, Report No.7, 2011, pg.54.

[19] Ibid, pgs.55-56.

[20] Ibid, pg.57.

...The definition will still need to be tested and determined in court proceedings that could prove lengthy. As a result, it may not provide clarity to franchising participants on their rights and obligations in the immediate term."

The SBDC notes an article prepared by the Deputy Chairman of the FCA, Mr Stephen Giles, in May 2012[21] which similarly arrived at this conclusion:

"..the franchise sector could live with the introduction of a new provision into the Franchising Code of Conduct that incorporated the existing common law duty of good faith into all franchise agreements. As the FCA has pointed out, the duty is likely to be implied into most franchise agreements anyway. The important thing is that good faith remains as defined under the common law, rather than some new and different defined statutory duty."

This would suggest that if a statutory obligation for good faith was to be inserted in the Code it should not be defined at this point in time because this leaves open the capacity for state and federal courts to develop the law on good faith in an unfettered way. For example, the High Court and many state courts are yet to consider what an obligation for good faith requires in the context of franchising relationships.

If an explicit obligation to act in good faith is introduced, what should its scope be? [Question 19]

Information about poor practices in relation to the franchising sector suggests that the need for parties to act in good faith arises throughout the franchising relationship. Unless it is possible to identify the issues in which franchisees are most vulnerable it may be preferable not to limit an explicit obligation to particular aspects of the franchising relationship.

Attempting to do so also risks limiting the scope of the obligation to circumstances that may otherwise have been subject to an implied good faith obligation at common law.

In summary, the SBDC believes that there are both advantages as well as disadvantages in introducing an undefined general statutory obligation to act in good faith in the franchising relationship.

Potential advantages include:

- reducing confusion as to whether such an obligation applies to franchising agreements so that courts do not have to determine its application on a case-by-case basis;
- increasing awareness of the obligation and putting franchisees and franchisors in a better position to seek legal advice on the obligation which could then be used when negotiating the terms of a franchise agreement;

[21] Mr Stephen Giles, Norton Rose, "Australia: Federal law reform to head off State based franchising legislation?", 14 May 2012, as appeared on www.mondaq.com.

- making an obligation for good faith a Code issue that can be mediated by state Small Business Commissioners or the Office of the Franchising Mediation Adviser ('OFMA');
- enabling regulation of the franchising sector (including the issue of good faith) to continue being managed on a nationally consistent basis through the federally regulated framework for franchising (thereby reducing the need for state-based regulation); and
- allowing the courts the scope to continue developing the law on good faith in franchising agreements without limiting its application to particular concepts.

On the other hand, potential disadvantages include:

- creating continued confusion as to what the obligation of good faith actually requires of individual parties to franchise agreements. As this will be subject to an objective rather than subjective test it is likely to lead to additional costs as franchisors and franchisees seek legal advice on the issue;
- court applications for a breach of the Code, based on a mandatory good faith obligation, is still going to be costly and beyond the reach of many small business franchisees;
- putting franchisees at risk of legal action by their franchisor for breaching good faith obligations in circumstances where the franchisor has greater resources with which to seek legal advice on the conduct of particular franchisees; and
- increasing pressure and expectations for the ACCC to act in relation to perceived breaches of the Code in areas that have previously been the domain of the parties to the contract (i.e. individual disputes between franchising parties).

Dispute resolution and Code enforcement

In the SBDC's opinion, access to justice for franchising parties in dispute has improved in recent years with the establishment of Small Business Commissioners and ADR services for small businesses in various jurisdictions, including Western Australia. In general, the various ADR services now available provide low-cost, speedy access to the resolution of franchise-related disputes, and can work in parallel with the services provided by the federally-sponsored OFMA and those offered by the private sector.

In Western Australia's case, the Small Business Commissioner's ADR service is an inexpensive, convenient way of resolving small business disputes, designed to get parties working together as soon as possible, thereby preserving the business relationship and reducing the need to "drag things through the court", which as noted earlier comes at great time and expense.

Based on a two-stage process, the Western Australian ADR service is able to offer small business franchise participants:

- free information, guidance and advice from experienced business advisors, including in relation to the rights and responsibilities under a franchise agreement and the overarching regulatory framework;
- assistance to informally help negotiate a workable outcome with the other party (through a process of guided resolution); and
- subsidised access to an independent mediator, where appropriate.

If the process of guided resolution has not helped resolve the dispute, private sector mediation may be offered where appropriate. In this case, each party to the dispute contributes $125 towards the mediation. Most disputes are generally resolved with one mediation session, whether an agreement is reached or not.

The small business ADR service has been operating at the SBDC since the end of March 2012. The overall proportion of franchise-related disputes considered by the service has been very low however, equating to around 1.33% of all business-to-business disputes received since 1 July 2012 (through to 14 February 2013). Put differently, in the past seven months the SBDC received only 24 enquiries related to franchising disputes out of almost 1,800 business-to-business disputes.

The additional avenues to access justice have also been coupled by improved enforcement of the Code by the ACCC in recent years. In the SBDC's opinion, the ACCC has been – certainly since the appointment of a Deputy Commissioner for Small Business and the introduction of enhanced enforcement powers under the Code – noticeably more proactive and effective in monitoring compliance with the franchising regulatory framework throughout Australia.

This has included a renewed focus on educating and informing prospective franchisees about their rights and obligations under the Code and legislation. The ACCC's support and promotion of the Griffith University-administered pre-entry education program for franchising participants, along with the previously mentioned Certified Franchise Executive program, are positive initiatives that aim to improve the overall standard of understanding of the nuances of franchising in Australia.

As was argued earlier, it is likely that this targeted form of education has led to improved knowledge and fewer misunderstandings (particularly among those new to the franchise business concept), and ultimately a lower rate of disputation between franchising participants. This information is important to equip prospective franchisees with the relevant knowledge to enable informed business decisions to be made. The programs' continued promotion by the ACCC (and other relevant bodies) is therefore supported and encouraged by the SBDC.

The introduction of new powers for the ACCC to conduct random audits of franchise systems has also likely resulted in improved franchisor behaviour. It is hoped that over time these new audit powers serve as an effective deterrent that should enhance the sector's overall conduct and compliance

with the Code. Randomly auditing franchise systems should also lead to better outcomes for franchisees as potentially non-compliant franchisors are identified earlier and suitably warned.

Pecuniary penalties and remedies

Despite these positive initiatives, the major outstanding issue in franchising relates to the lack of effective penalties and remedies for breaches of the Code. While the Code contains a plethora of provisions, no penalties for breaching these are explicitly stipulated. As noted by the ACCC's Deputy Commissioner for Small Business, Dr Michael Schaper, "It has become apparent that the absence of meaningful penalties makes it more difficult for us [the ACCC] to successfully enforce the Code."[22]

As such, there appears to be a stronger case for introducing civil penalties for breaches of the Code. However, given that pecuniary penalties are likely to be used to deter major and systemic breaches of the Code, and could be detrimental to the relationship between a franchisor and particular franchisees, they should only be introduced as one of a range of further remedies.

That is, remedies for breaches of the Code should also include other enforcement mechanisms, such as enforceable undertakings, injunctions, adverse publicity orders and infringement notices. This would enable the ACCC to apply the remedy that best fits the conduct breaching the Code, thereby creating the strongest possible deterrents against misconduct.

The SBDC welcomes the opportunity to provide this submission to the Code review. If you would like to discuss any of this in more detail, please contact Mr Martin Hasselbacher, A/Director of Policy and Advocacy, on (08) 6552 3302 or email martin.hasselbacher@smallbusiness.wa.gov.au.

Yours sincerely

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SMALL BUSINESS COMMISSIONER

25 March 2013

[22] Dr Michael Schaper, in a speech presented to the Franchise Council of Australia on 7 October 2012.